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"Working Capital Management System": A Performance Based Study

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Abstract:
As one of the important section of financial management, working capital management reflects its relevance towards business's improvement. This paper builds a management system with reference on the modifying cycle of working capital management performance. Specially, the system includes five elements, they are management goal, business environment, management policy, management mode and management performance. This study targets to offer a theoretic way for working capital management practices.

Keywords: *Working capital, performance management, management system.*

1. Introduction

Working capital is basically a gap between current assets and current liabilities. It reflects the qualified stability of short-term capital. A business's financial risk can be valued, by the value of working capital and some related factors. The higher working capital a business would own, the less financial risk they may come across. However, excess working capital is not advisable for the business entities who wish a long-term business gowth , as they would lose profits over investments . We suggest to improve the working capital management, for its relevance and financial stability. To perfect the management process, we propose an efficient working capital management system on performance, which may be a modifying cycle.

2. Review of Literature

Working capital is explained in a broader sense and a narrower sense. The broad working capital, also known as the total working capital, is the value of current assets. George William Collins [1945] pointed out that working capital is the part of current assets over and above the current liabilities, which is defined as net working capital M. Fu-gen [1995].

Most of the researches done all over the world consider working capital as one of the important aspect of financial management, working capital management and the financial management goal of a business should be consistent with each otherJ. Feng [2006], which is generally considered in academia. Hyun-Han Shin and Luc Soenen [1988] noted that actual working capital management should think of shareholders's and investor's value.

Li Xiaoqun [2005] stated that the management's aim of an organisation is to increase profitability and decrease financial risk. Working capital management goal should follow the business entity's financial goal. Effective working capital management needs an overall examination on the environment, like economic environment, industrial features and its own characteristics.

Lu Lianhua [1988] stated that the ratio of working capital to assets in different industries in United States were varies. Besides, business entity's own operating conditions and external financing ability were the key reference to Liu Huaiyi [2010], when he was scrutinizing the management of working capital in retail. This reveals that working capital management should consider macro and micro business environment, rather than a simple figment.

Mao Fugen [1995] explained it as well organised management. He pointed out that working capital management policy should be based on the risk-return, determine the ratio of current assets and current liabilities to total assets respectively, and then to make joined result.

Mao Fugen [1995] bifurcated the working capital management policies into radical, moderate and steady, based on his study above. Each policy corresponds to a certain current assets and current liabilities ratio, which reflects the balance between risk and return.

The commercial credit helps to accelerate cash flow, then to realize the efficient working capital management. With the opening international markets and a growing application of financial derivatives, Wang Zhuquan [2009] introduced several innovative modes for working capital management, such as export credit insurance, repurchase guarantee sales etc.

3. Working Capital Management System

Forming a working capital management system is to strengthen the management and make it more methodical in order. Moreover, an effective management system should be applicable to all types of working capital management practices, and be regularly reparable for further improvement. To meet this need, we propose a management system based on the performance management theory. In particular, the system include the following five consistent elements, they are management goal, business environment, management policy, management mode and performance evaluation. The relationships of these elements are shown in the further discussed figure.

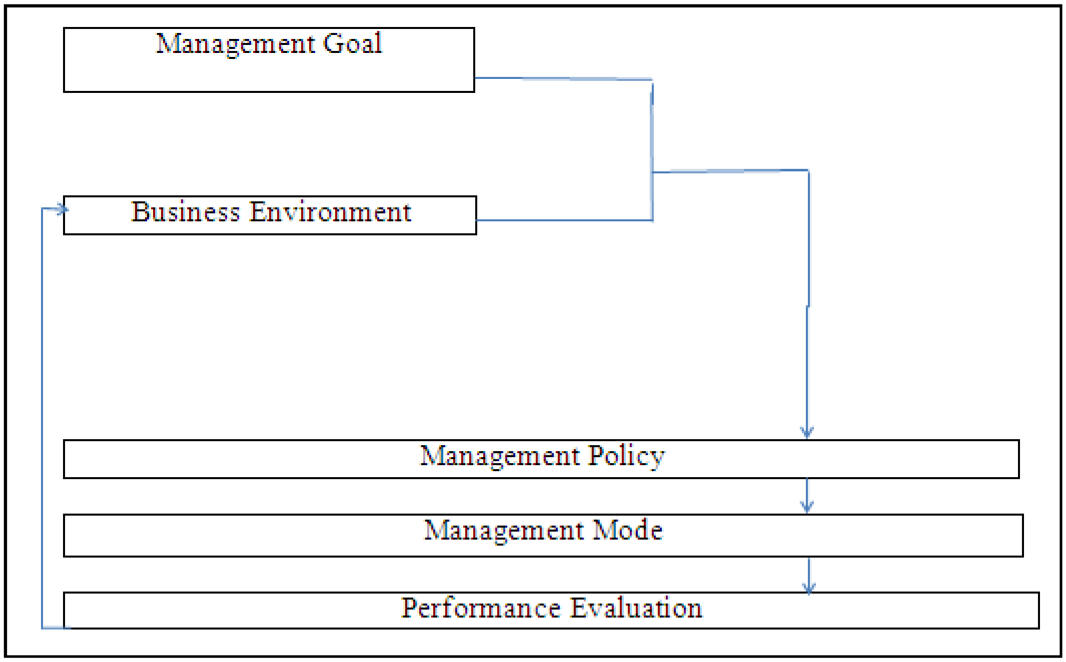

Figure 1

- Mangement Goal & Business environment – Management policy – Management Mode – Performance Evaluation (indicate the logical sequence between these elements.
- Performance Evaluation – Business Environment (indicates the modifying cycle)

The complete management system is under the guidance of the business entity's goal. Furthermore, its management policy is based on the business environment and enterprise's capacity assessment. After execution of the policy would be the working capital management performance evaluation. According to the performance result, we will involve in the modification of working capital management system. The system is a cycle to achieve the long-term improvement of working capital management.

3.1. Management Goal

Management goal is the primary objective of working capital management system, which guides the complete management process. Therefore, achieving the working capital management goal is a priority. Thus business entity's value maximization could be the ultimate goals to achieve. That shows the connectivity between working capital management and financial management, at the same time, it also reflects the service relationship between them. Specifically, we will subdivide the goal into profitability, risk and efficiency. Some working capital items such as inventory, accounts receivable, accounts payable, debtors, accrued wages payable, taxes payable and so on arise from the regular operating activities, for which are focused on their profitability. Some working capital like cash, securities, dividends receivable, current liabilities, interest payable and so on are about the manifestation of liquidity and debt, which may principal expedition the risk. The management efficiency is mainly reflected through its turnover situation.

3.2. Business Environment

Assessment the current business environment is a prerequisite to working capital management. In a broader sense, there are external and internal environment. Specifically, the environment includes economic situation at home and abroad, like the industrial characteristics, production and sales, cash control and so on. We will know the business demand and operating risk for working capital through the environment assessment, which can help us make targeted working capital management policy. Industrial characteristics affect working capital requirements in a large extent, as well as the enterprise's own capacity. In General, the working capital requirements in retail may be less than that in manufacturer, as their relatively lower value of inventory and the little credit. In addition, the management of accounts payable recovery and bargaining power to upstreams are also important factors. Even if in the same industry, enterprises who can timely receive the receivables or defer payables may own less working capital, because of an efficient turnover. Economic situations at home and abroad such as the national economic recession, inflation, interest rate, exchange rate and so on will also affect working capital items in various ways.

3.3. Management Policy

Enterprises have to keep a certain amount of working capital to meet their needs, at the same time to spend the cost. Thus, working capital management policy implies a comprehensive consideration of risk and the cost. In accordance with the working capital requirements over time, we divide it into permanent and temporary. Permanent working capital is held for normal operation. While temporary working capital is for the high season. Steady management policies require a certain amount of temporary working capital on low season. And the radical policies relax the requirements for permanent working capital. The radical working capital management policy spends lower capital cost by increased operating risk. Usually, the enterprises who manage working capital efficiently will gain valuable investment opportunity from the reduced cost. Those who select steady working capital management policy seem to be risk followers. By holding more working capital, enterprises can easily cope with sudden changes, which gains from the high cost. Under the instability external economic environment when the enterprise is counter-measures, the steady policy would be a good choice. Regardless of which management policy, the one is guided by the goal and combined with the business environment, is what we need.

3.4. Management Mode

The management mode is matched with working capital management policy, which is a specific implementation for the management process. We believe that the mode which concerns on value chain of up and downstream is better, as the most important items in working capital arise from those areas. Strengthen the control of value chain can gain more with less. Direct management for highly-liquid items like cash, short-term debt and so on is also very important, as they are important parts of working capital. To this end, we recommend that the working capital management mode can regard the value chain management as an importance and the direct management as an aid. The working capital management mode reflects the risk-attitude of enterprise. Those managers who courage to accept the risk seems to focus on value chain. By improved bargaining power to channels, they can reduce the cash holdings to meet working capital's needs. When the items are not so good on the liquidity, firms tend to hold cash or reduce short-term debt. Direct management allows managers to deal with the risk calmly and catch good investment opportunity.

3.5. Performance Evaluation

Performance evaluation is a summary of the past working capital management, where we can find problems and prepare for the management process modification. The set indicators to reflect performance, will be taken to compare with the other enterprises' in the industry or its plan, then we can get the information on working capital management performance. To make the results more reliable, we should pay attention on comparability and evaluation useful when choose enterprises for external evaluation. If the enterprise is not comparable, or itself is poor in the management, the working capital performance evaluation seems meaningless. Evaluation indicators are important elements of the performance evaluation, which are based on the management goal and combine with the operating requirements. Profitability is reflected by the relationship between working capital and cost or revenue. Its main financial indicators are working capital productivity, sales planning ratio and so on. The financial risk of working capital management arises when capital holdings is unable to meet their actual demand. So main indicators are working capital requirements, working capital adequacy ratio and so on.Traditional performance indicators reflects the management efficiency of working capital, like cash conversion cycle, inventory turnover ratio and so on. In addition, to enhance the channel management, working capital cycle can be divided into procurement, production and marketing channel cycle. So that we will get the information on the operation of different segments. There is no mandatory provision on working capital management performance indicators, but consistent within the industry will contribute to comparison and evaluation.

4. Working Capital Modifying Cycle

Performance-based working capital management system should be a cycle. Performance evaluation is on the end of the last stage, the results, at the same time, become a beginning of the next stage for management modification. Generally, the modification is start from the business environment assessment, and does not involve the management goal. Unless the operating environment is undergone significant and irreversible changes, and then it changes enterprise's overall strategic goal. Reassessing the business environment is to ensure that working capital management system can always match to it. For a bad evaluation result, we believe that issues arise in unmatchable management policy or inappropriate implement. To that end, managers need to analyse the source and make adjustments. The unmatchable policy means that working capital management policy isn't suit to the business environment. Matchable management policy still may fail, if with ineffective implementation. A communication about the working capital management with staff is essentially, to help them acknowledge on the management policy, and implement actively. Performance management cycle is for the long-term development of enterprise's working capital management, including the modification of the management issues and the consolidation of efficient management. Through continuously management process, modification and consolidation help us reach the final working capital management goal.

5. Conclusion

We choose working capital management process as the study object, and then construct a set of management system based on the performance. For the whole management process in enterprise, management goal is the guidance. A matchable working capital management policy should consider about the internal and external business environment, besides, efficient execution is also needed to get high performance. While, the final goal relays on the modifying cycle of working capital management, which is based on the performance. What's more, it also requires courage to deny and innovate. Totally, the five management elements work together for working capital management.

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